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DOMESTIC ECONOMY REMAINS BASICALLY SOUND DESPITE RISING THREAT FROM FOREIGN SECTOR

by Richard W. Rahn and Graciela Testa-Ortiz

Despite the unexpected weakness of the first quarter's preliminary estimate of total GNP growth, the domestic economy remains basically sound. Excluding the $73 billion decline in first quarter net exports, real GNP would have grown by 4.4 percent. The U.S. economy shows every sign of having settled into a healthy growth path.

Estimates for the first quarter show a strong consumer sector fueled by continued employment and income gains. While the civilian unemployment rate remained at 7.3 percent in February and March, this figure hides the continued ability of the U.S. private sector to create new jobs. Since mid-1984, even while the economy's growth slowed to a more sustainable pace, almost 2.2 million new jobs were created in the nonfarm sector. During the months of February and March alone, the economy created 493,000 new jobs. Furthermore, the percentage of the population at work in March rose to 60.3 percent, the highest rate in the nation's history.

During the year to February personal income rose 7.4 percent, fueling an 8.1 percent rise in consumer spending. Purchases of durable goods, and services remain strong, contributing to an impressive rise in February retail sales. Although March retail sales dropped 1.9 percent, this came on the heels of an unusually strong rise in February sales. Although the March data show a considerable decline in retail sales, they remain 5.8 percent higher than their year-ago level. Domestic automobile sales during the first quarter averaged 8.4 million units, and production plans for the second quarter remain optimistic. Sales of new single-family homes rose by 6.5 percent in February, a 15 percent increase from their August trough.

Business fixed investment has also experienced a respite, growing by only 8.5 percent in the fourth quarter of 1984, following five quarters of annual growth rates in the double digit range. But although the industrial production index fell in February, indications are that the lull may be over. The index of leading indicators rose for the third consecutive month, following several months of erratic movements. Presaging future increases in production and investment, orders for nondefense capital goods rose by almost 30 percent. Housing starts have remained above the 1.6 million unit mark since the beginning of the recovery, averaging 1.7 million units during the first three months of this year.

Buffeted by the combination of a strong dollar and weak foreign demand, U.S. merchandise exports fell sharply in February, contributing to an $11.5 billion merchandise trade deficit, even though imports also fell. Exports fell eight percent in February, the largest monthly decline in seven years, while imports declined by only 1.3 percent, primarily reflecting lower petroleum imports. Although the trade-weighted exchange value of the dollar has eased by about six percent in the past month, it is still more than two percent higher than it was last December. For further details regarding the dollar see the article, *The Mystery of the Dollar* in this issue.

The continual increase of protectionist pressures in the United States, particularly those geared towards Japan, raise the specter of an all-out trade war which threatens world trade. The trade deficit with Japan has widened significantly, now standing at $36.8 billion. The Reagan Administration continues to negotiate for easier access to Japanese markets, particularly in semiconductors and telecommunications. The U.S. and Japan are being drawn inexorably toward a protectionist showdown as Congress edges closer to converting verbal threats into retaliatory

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TABLE 1
UNITED STATES ECONOMIC OUTLOOK 1983–1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS								YEARS		
	Actual		Forecast						Actual	Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	4.3	1.3	4.2	4.5	5.1	4.8	4.6	4.6	4.7	6.8	3.4	4.7
Consumption	3.6	4.7	3.9	4.0	4.0	4.1	3.7	3.6	4.0	5.3	3.9	3.9
Residential Investment	-5.9	-0.8	7.6	14.0	6.4	6.0	8.1	10.5	10.3	12.2	1.7	8.4
Business Fixed Investment	8.5	3.5	5.6	8.8	10.3	10.3	11.0	8.1	9.7	19.8	8.3	9.6
Equipment	5.4	-0.6	6.8	8.8	10.9	10.6	11.0	8.2	9.4	21.5	7.3	9.9
Structures	17.2	16.0	2.8	8.7	8.8	9.3	10.8	7.8	10.6	15.6	10.7	8.9
Exports	-0.8	-8.2	5.4	7.2	9.5	10.5	12.4	10.9	10.5	4.7	1.1	10.0
Imports	-28.3	26.1	11.1	4.6	8.1	6.9	6.4	5.2	6.2	27.0	8.7	6.7
Government Purchases	5.9	0.2	5.0	3.8	2.6	2.3	1.8	1.6	2.0	3.5	4.5	2.5
Inventory Change ($B)	36.6	46.6	51.7	46.4	51.0	51.6	48.9	49.5	47.7	58.2	48.9	49.4
New Car Sales (mil. units)	10.2	10.8	10.9	11.2	11.2	11.3	11.3	11.5	11.5	10.4	11.0	11.4
Housing Starts (mil. units)	1.6	1.7	1.8	1.8	1.9	1.9	2.0	2.0	2.1	1.8	1.8	2.0
EMPLOYMENT, WAGES AND PRICES												
Unemployment Rate (%)	7.2	7.3	7.3	7.2	7.1	7.0	6.9	6.8	6.7	7.5	7.2	6.9
Compensation	3.6	6.2	4.3	4.4	5.3	6.6	5.9	6.2	6.8	4.2	4.6	5.8
Productivity	2.7	1.8	3.0	2.5	2.4	1.7	1.4	1.8	2.3	2.8	2.2	2.0
Unit Labor Costs	0.8	4.3	1.3	1.9	2.8	4.8	4.5	4.3	4.4	1.4	2.4	3.7
Consumer Prices	3.5	3.1	2.6	2.9	3.4	4.0	4.0	4.0	4.2	4.3	3.2	3.7
GNP Deflator	2.8	5.0	1.6	2.0	2.5	3.3	4.0	4.3	5.0	3.8	3.2	3.3
Prime Interest Rate (%)	11.8	10.5	10.4	9.8	9.3	9.2	8.7	8.5	8.1	12.0	10.0	8.6
Profits from Current Production ($B)*	203.9	14.6	223.5	223.0	224.1	221.4	224.1	227.0	229.4	196.2	221.3	225.5
GOVERNMENT FISCAL POLICY ($BILLION)**												
Unified Budget–Receipts										666	736	983
Unified Budget–Outlays										842	949	798
Unified Budget–Federal Surplus or Deficit										-175	-213	-185

*Corporate profits after tax with inventory valuation and capital consumption adjustments.

**Unified Budget figures on a fiscal year basis.

Source: Modeling and assumptions by U.S. Chamber of Commerce, Forecast Center using the DRI macro model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to pass a deficit reduction package which results in a static reduction in federal government outlays of $40 billion in calendar year 1986. The money supply as measured by M(1), is expected to grow by 6.7 percent in 1985 and 7.2 percent in 1986. The marker price for OPEC oil is anticipated to fall to $26 per barrel in 1986. The federal minimum wage remains at $3.35 an hour throughout the forecast interval. The trade-weighted exchange value of the dollar is expected to rise by three percent this year before declining by 5.6 percent in 1986.

legislation. U.S. exporters are increasingly hampered by the strong dollar, sluggish growth in our trading partners' economies and import barriers—especially in Japan. However, the implementation of protectionist actions may serve to incite retaliatory measures from our trading partners, which will severly limit our export performance. The threat of foreign retaliation is a real possibility, in fact, the European Parliament has already passed a resolution calling for just such action should the U.S. enact an import surcharge. Unfortunately most of the protectionist actions being proposed will cause far more pain to the U.S. consumer, and ultimately to U.S. economic growth than to our trading partners. Such masochistic measures need to be firmly resisted.

As the economy's expansion continues to settle, the public policy risks become more onerous. While the absence of tax increases in the White House/GOP Leadership compromise package of deficit reductions is a good omen, the risk of higher taxes is not altogether over. In fact, fears of a watering down of ACRS and the elimination of the investment tax credit under a compromise tax reform package, may improve the near-term investment outlook as firms accelerate their spending plans to take advantage of tax incentives which may disappear. However, this development may bode ill for investment spending in 1986 and beyond since it would significantly raise the cost of capital and lower business investment and productivity. For further information on these issues, see *The Productivity Challenge* and *Capital Cost Recovery and Tax Reform* in this issue.

In sum, given the first quarter weakness of real GNP growth, our forecast shows weaker growth rates for 1985 and 1986, on a year-over-year basis. Nevertheless, the quarterly growth rates are anticipated to remain close to five percent, a very healthy rate for the third year of an economic expansion.

THE PRODUCTIVITY CHALLENGE

by Graciela Testa-Ortiz

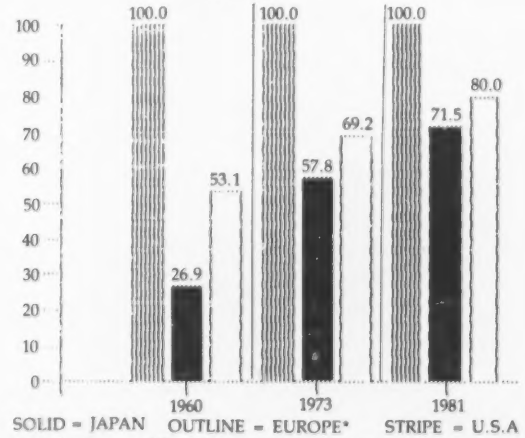
Growth in productivity, that is, the efficiency with which inputs of labor, capital, energy, and materials, are used in the production process, is the key to long-run economic health and a rising standard of living. Simply put, the more we produce, the more we have to consume and invest.

This suggests a challenge to our nation's policy makers. The data show that the major impact on recent productivity trends has been the result of the 1980s reversal in public policy choices which placed an emphasis on economic stability, increased incentives to save, work and invest, and the move towards deregulation of certain key industries. The challenge before us now is to ensure that the long-run health of the U.S. economy remains a prime consideration. Further improvements in productivity, and indeed, the reversal of the 1970s trend, are predicated upon the continuation of these policies.

A 1984 study by Harris Trust and Savings Bank of Chicago concludes that under present legislation, effective marginal tax rates could rise by 2.8 percentage points between now and the end of the decade. The effect of this increase in tax rates on productivity would be to negate recent improvements and return the economy to the lackluster performance of the 1970s. According to their study, by the end of the decade the economy would be producing $180 billion fewer goods and services—the equivalent of $3,000 per American family—than would be the case if the present productivity trend were to continue. In addition, most of the tax reform proposals now under consideration would increase the cost of capital (see *Capital Cost Recovery and Tax Reform*, in this issue), further dampening capital investment, productivity, and the outlook for overall economic activity.

The urgency of facing up to this challenge becomes even more important when we note that in spite of the improvement recently experienced, differences of opinion exist as to whether this increase in productivity represents a turnaround in the downward trend which began in 1973, or if it is only a cyclical phenomenon. Furthermore, the latest data show that while the upturn in productivity during the recovery was significant, the rise in both nonfarm business and manufacturing sector productivity remains below the average for similar periods during

CHART 1
GROSS DOMESTIC PRODUCT
PER EMPLOYED PERSON
(percent)



*Includes France, West Germany, Italy and the United Kingdom.

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the past four recessions (excluding the 1958 and 1980 recoveries which did not last as long as the current episode). Also, while the U.S. productivity level remains above that of our major trading partners, chart 1 shows that these nations are rapidly catching up with the U.S. level.

WHY IS STRONG PRODUCTIVITY GROWTH IMPORTANT?

Increases in output per unit of input affect the economy in ways other than just raising efficiency and allowing for increased production with a given level of resources. Inasmuch as productivity increases are the major source of improvements in the hourly compensation of employees, they allow for increases in the standard of living of a country's residents.

Productivity also has an impact on inflation. Any increase in nominal wages beyond that justified by improved labor productivity results in rising costs and increased price pressures. By reducing unit labor costs, productivity improvements curtail increases in inflation.

Further, a strong rate of growth in productivity enhances the economy's international competitiveness, because highly productive economies can offer their goods and services in the international marketplace at relatively lower prices than their less productive competitors. Consequently, strong productivity growth buoys exports and GNP.

TRENDS IN PRODUCTIVITY PERFORMANCE

During the 1970s, U.S. productivity performance slowed dramatically. Productivity in the private business sector slipped from a 3.4 percent average annual rate of growth in the 1960s, to 1.7 percent during the 1970s. Looking at the period prior to 1973, when the 1970s slowdown became evident, shows that between 1948 and 1973, output per hour rose at an average annual rate of 3.7 percent, but the increase slipped to only 2.2 percent per year between 1973 and 1981. Another way of examining the productivity slowdown is to remove cyclical movements in the index by comparing periods with similar rates of capacity utilization. This shows that between 1954 and 1972 the productivity trend averaged a rate of growth close to two percent, but that it fell to only 0.9 percent between 1972 and 1978, and 0.2 percent between 1977 and 1981.

The 1970s slowdown in productivity growth was not isolated but represented a worldwide phenomenon. Growth in manufacturing sector productivity fell by 0.5 percentage points in the U.S. during the 1970s compared to the 1960s. It fell by 6.3 percentage points in Japan, and an average of 2.5 percentage points in France, West Germany, Italy and the United Kingdom. During the first three years of this decade, U.S. productivity performance increased slightly relative to the experience of the 1970s, while productivity in Japan, Canada, France, Italy, and West Germany continued to slide (see table 1).

The explanation for this slowdown in output per hour can be found by studying the 1970s performance of the factors that determine productivity growth. Productivity is affected by a host of interrelated factors. These include the demographic characteristics of the working population; the rate of capital formation and the quality of the capital stock; shifts in the economy's industrial composition; the amount of resources devoted to research and development; inflation; energy shocks; government regulation and tax policy; capacity utilization; and even the attitudes of workers and managers towards productivity.

TABLE 1
GROWTH IN MANUFACTURING PRODUCTIVITY
(average annual percent change)

	1950–59	1960–69	1970–79	1980–83	1982	1983
U.S.	2.3	3.6	3.1	3.2	2.1	4.2
Canada	4.5	5.6	4.0	1.9	−2.8	6.4
Japan	12.5	16.4	10.1	6.6	8.2	5.0
France	5.6	9.0	6.6	4.9	5.5	5.9
W. Germany	9.8	8.1	5.7	2.6	1.2	4.7
Italy	7.2	10.0	5.8	2.7	2.8	1.6
U.K.	1.9	4.6	3.5	5.8	3.9	6.6

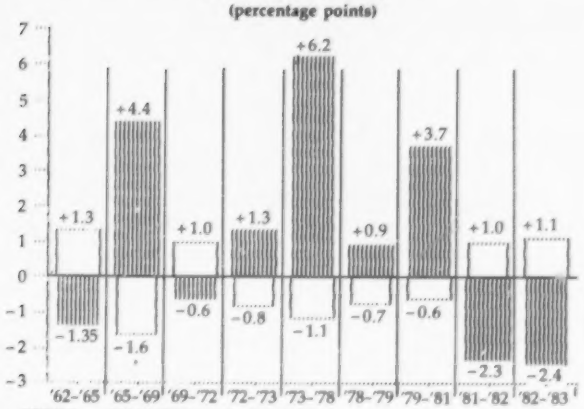
Source: Bureau of Labor Statistics December 1984

Explaining the Slowdown: Government Policy

Of this long list of determining factors, some, such as demographics and the energy shocks of the 1970s, are beyond public policy influence. However, those factors that can be influenced by public policy are the most important ones, not only because they are amenable to change, but also because they can be shown to have an impact on the remaining factors. For instance, we have listed educational attainment, savings and investment as important variables determining productivity. However, policy decisions can and do affect these variables. What motivates people to work, save, invest and improve their productive efficiency? Part of the answer lies in the marginal tax rates associated with an economy's revenue system. Higher taxes have an immediate adverse effect on productive work, savings and investment. Wage and salary workers, as well as entrepreneurs, may find it more attractive to substitute leisure for work, or avoid new ventures, as additional earnings and profits are taxed at higher rates. High tax rates, therefore, result in an inefficient allocation of resources.

In support of this, studies have found that changes in structural productivity, that is, productivity adjusted for the impact of business cycles, coincide with changes in tax rates: during periods in which tax rates have risen, productivity has fallen. Evidence suggests that, since the 1950s, a one percentage point change in effective marginal tax rates has been associated with a 0.33 percentage point

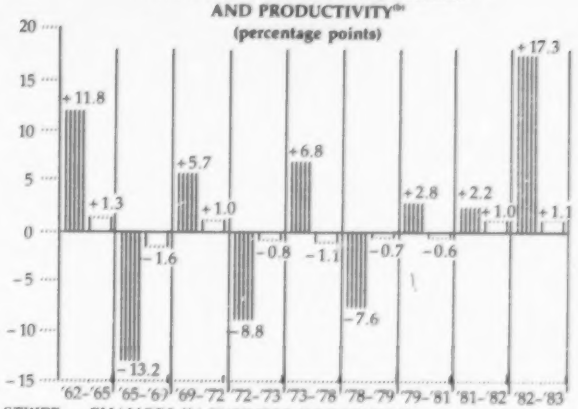
CHART 2
CHANGES IN TAX RATES[a] AND PRODUCTIVITY[b]
(percentage points)



STRIPE = CHANGES IN TAX RATES
OUTLINE = CHANGES IN PRODUCTIVITY
(a) Tax changes are differences in effective marginal rates.
(b) Productivity changes are differences in structural trends.

Source: Robert Genetski, "The Impact of Marginal Tax Rates on Productivity Performance," testimony submitted to the Congressional Subcommittee on Oversight of the IRS, April 13, 1984.

CHART 3
CHANGES IN BUSINESS INVESTMENT[a] AND PRODUCTIVITY[b]
(percentage points)



STRIPE = CHANGES IN BUSINESS INVESTMENT
OUTLINE = CHANGES IN PRODUCTIVITY
(a) Changes in business investment are percentage point differences between the average annual growth rates in real nonresidential fixed investment with a one period lead.
(b) Productivity changes are differences in structural rates.

Source: U.S. Chamber of Commerce, Forecast Center and Robert Genetski, *ibid.*

change in productivity in the opposite direction. Chart 2 shows the importance of changes in effective marginal tax rates on productivity quite dramatically.

The productivity crisis during the 1970s began with the first oil price shock of 1973 and was compounded by a series of negative policy decisions which exacerbated the impact of the variables beyond policy influence. As an excessively accommodative monetary policy corresponded with the rise in energy costs, inflationary pressures spiraled. When combined with tax and regulatory impediments, this reduced the rate of growth in business investment, in turn, contributing to the deterioration of worker productivity that occurred after 1973.

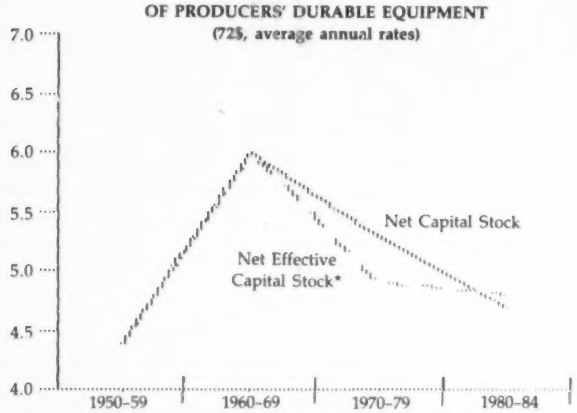
Increases in capital investment enhance productivity by making more and better tools available to workers. Mechanizing a production process results in a higher level of output per worker. Chart 3 shows the relationship between changes in business fixed investment and changes in nonfarm productivity. Note that the time periods chosen coincide with those in chart 2, that is, they are representative of periods which witnessed reductions in marginal tax rates. Charts 2 and 3, therefore, make clearly evident the link between marginal tax rates, capital investment and productivity performance. The only exceptions are the years between 1973 and 1978, and 1979 and 1981 when business investment rose, but productivity fell. This aberration may be explained by the massive rise in regulatory requirements. Between 1973 and 1981 capital expenditures for pollution abatement rose at an average annual rate of over 20 percent, thereby diminishing the investment in productivity-enhancing equipment.

Periods of rapidly growing inflation coincide with low productivity growth, although the relationship is far from coincidental. An inflationary environment, combined with a tax system which does not take inflation into account, seriously depresses productive investment. This was exactly the situation before the enactment of the Accelerated Cost Recovery System (ACRS). During the 1970s, depreciation allowances were based on historical cost and were, as a consequence, inadequate to compensate for the increase in replacement costs which resulted from rapidly rising prices. Inflation raised the tax burden on businesses as well as the cost of capital, curtailing the growth of investment in productivity-enhancing plant and equipment. Further, before the enactment of income tax indexation, inflation-induced bracket creep raised marginal tax rates on individuals, reducing incentives to save, work and invest. And, the tax deductibility of interest payments, by encouraging the use of consumer credit, further restricted the pool of savings available for investment.

The 1970s was also a decade of rapid growth in government regulation. Regulations for pollution, health and, safety compounded the effect of inflation and tax impediments on productivity. In order to comply with these regulations, firms had to channel their investment spending away from updating their plant and equipment, and towards meeting these new standards. Even though these expenditures yielded an intangible benefit in the form of a cleaner environment and a potentially safer workplace, they did nothing to improve or expand productive capacity. Indeed, between 1972 and 1980, expenditures for pollution abatement and control rose by 200 percent—an average annual rate of 25 percent—while nonfarm labor productivity rose by only 0.7 percent per year. As chart 4 shows, the nation's net capital stock grew at a slower rate in the 1970s than it did in the 1960s. Further, the net capital stock adjusted for expenditures such as pollution

abatement, rose at a slower rate that the unadjusted series.

CHART 4
GROWTH IN THE NET CAPITAL STOCK
OF PRODUCERS' DURABLE EQUIPMENT
(72$, average annual rates)



*Adjusted for expenditures such as pollution abatement.

Explaining the Slowdown: Other Determining Factors

Public and private investment in research and development, by paving the way for the development and introduction of innovations and new technologies, also plays a significant role in enhancing productivity. Although the link between R&D spending and technological improvements in the production process is difficult to quantify, studies show that the direct returns to R&D spending are approximately 20 percent. During the past decade, public and private R&D spending accounted for 1.6 percent of GNP, compared to two percent between 1963 and 1969.

Demographic factors also affect worker productivity. Important among these is the age structure of the working population. Productivity is enhanced if the fastest growing segment of the labor force is in the 25 to 54 age group, that is, representative of more experienced workers. Alternatively, when the proportion of the 16 to 24 year old population is growing more rapidly, productivity tends to decrease as these workers have little work experience and low skill levels. The sex composition of the labor force is also important. A large influx of women into the labor pool may depress productivity because, by and large, women have tended to have less work experience than men of the same age group due to their later entry into the work force. The level of educational attainment of the population also has a bearing on labor productivity. Increases in the proportion of the work force with four or more years of college education have been shown to have an important impact on productivity.

During the 1970s, the labor force grew at a 2.6 percent rate, with the bulk of new entrants being the baby boom generation and women, each entering the job market with limited skills and experience. Between 1948 and 1981, the proportion of the work force in the 16 to 24 age bracket rose from 19.5 percent to 23 percent. At the same time, the proportion of women in the labor force rose from 29 percent to 43 percent. This combination lowered the average level of experience of the labor force. The educational level of the work force, on the other hand, improved significantly, mitigating some of the negative effects of the age-sex composition.

Any shift in the composition of output away from low productivity sectors enhances productivity. The movement from farm sector employment to the nonfarm business sector raised productivity between 1948 and 1973. During the past two decades, the shift in output and employment from manufacturing to the services sectors has become more apparent and led some to believe that it has depressed productivity growth. However, the data do not support this perception; in fact, they point to a positive impact on total factor productivity.

The misconception has arisen from the widespread reliance on the one-dimensional measure of labor productivity, rather than total factor productivity, as a measure of economic efficiency. However, labor productivity does not take into account other factor inputs, or changes in their mix. The increase in productivity in the service sector, in both absolute and relative terms, has come about as a result of the contribution of capital rather than labor, the increased use of computers – the emerging paperless office and CAD/CAM processes – being prime examples. To be sure, some industries within the service sector, such as in the business and personal services categories, do have a low productivity performance. However, these represent a small percentage of the total service sector.

RECENT EXPERIENCE

So far this decade, the U.S. economy has experienced a substantial turnaround in productivity performance. Since the end of the recent recession, nonfarm business sector productivity rose by 6.7 percent, while manufacturing productivity increased by 7.6 percent.

To be sure, factors beyond the control of government policy have enjoyed a significant improvement during the 1980s. The age-sex composition of the U.S. labor force has now become an enhancing rather than retarding factor as the baby boom generation moves into the more productive age groups. The young, inexperienced workers of the 1970s are becoming the mature, experienced workers of the 1980s. Furthermore, the likelihood of a repetition of the energy price shocks of the 1970s is virtually nil. If anything, world oil prices are expected to remain soft throughout the rest of the decade (see *World Oil Markets: What Now?*, ECONOMIC OUTLOOK, May, 1984).

However, the most significant factor contributing to the improvement in the outlook for productivity stems from the positive policy developments instituted during the first Reagan Administration. The Keynesian adage that "in the long run, we are all dead," contributed to the short-sighted management of economic policy. Now, the long run has regained its importance.

Policies instituted since 1980 have been explicit in their concern for the economy's long-term health, and their impact is readily apparent. The emphasis on deregulation, lower tax burdens, capital formation and economic stability has already yielded results. Expenditures for research and development have rebounded, reaching about 2.7 percent of GNP, close to its 1968 peak. Further, the impact of increased R&D spending on productivity is likely to be larger during the 1980s than it was during the past decade, when companies found it necessary to spend large amounts of funds to offset rising energy costs and comply with new regulatory requirements.

The Economic Recovery Tax Act of 1981 (ERTA), and in particular, its provisions for accelerated depreciation and indexation of personal income tax rates, has reversed the pattern of rising tax burdens which thwarted business investment in the past. As a result, not only has this recovery witnessed the largest rise in business fixed investment of any post-war recovery, but the ratio of business investment to GNP has averaged 11.5 percent during the last five years, and reached a record of 12.5 percent during the last quarter of 1984, compared to 10.7 percent in 1970-79 and ten percent in 1960-69.

The Harris Trust study mentioned above, concludes that the bulk of the improvement in cyclically-adjusted productivity between the third quarter of 1981 and the end of 1983 is attributable to the enactment of the Economic Recovery Tax Act of 1981. Chart 2 above, shows the improvement in cyclically-adjusted productivity which followed the ERTA reduction in effective marginal tax rates.

CONCLUSION

The implication is that "leaving well enough alone," will not be sufficient to maintain the levels of productivity recently achieved—further progress is imperative. What this country needs, then, is a commitment to those policies which have already proven their efficacy. The move towards deregulation, a major component of the policies of the first Reagan Administration, has recently waned (see *Lightening the Load of Regulation*, ECONOMIC OUTLOOK, December 1984). A recommitment to this ideal is paramount to the achievement of further increases in productive investment. Privatization of government services, a goal which has received some lip-service, should be aggressively pursued. A shift in output and employment away from the relatively less productive public sector will enhance economy-wide efficiency (see *Privatization of Government Services: Improved Efficiency at Lower Cost*, ECONOMIC OUTLOOK, December 1984). Noninflationary monetary policy, which has been remarkably successful thus far, should remain a prime public policy aim. Finally, since current tax legislation implies a gradual increase in effective marginal rates, a reversal of this trend is clearly necessary if we are to solidify the productivity gains recently achieved.

THE MYSTERY OF THE DOLLAR

by R. Bonnie Ohri

Few propositions are so often stated with as much confidence by economists and commentators as the following: First, the dollar is "overvalued"; second, the strong dollar harms our economy while a weaker dollar would reap more benefits for exporters; third, the strong dollar is responsible for the increase in the trade deficit; and finally, official intervention in the foreign exchange markets will lower the value of the dollar. The confidence with which these propositions are being stated derives not from experience and analysis, but from the belief that they are intuitively obvious and from their endless repetition by the media.

But, as this article demonstrates, the validity of these propositions is limited. The purpose of this article is to carefully consider these views so that attempts to solve the dollar dilemma do not inflict serious damage on the U.S. economy.

Is the Dollar Overvalued?

For some time, certain public and private sector policymakers, businessmen, and academics have held the view that the value of the dollar is too high in relation to the currencies of our major trading partners. Between late 1980 and 1984, strong demand for the dollar pushed up its value by 40 percent against the British pound, 50 percent against the German mark, over 100 percent against the French franc, and 15 percent against the Japanese yen. Yet, there is no operative standard by which to judge whether, and by how much, the dollar is overvalued. The dollar is, generally speaking, responding to market forces. Although the idea of an overvalued dollar is rapidly becoming part of today's conventional wisdom, it is very difficult to define and even more difficult to defend.

Just what does it mean to say that the dollar is "overvalued"? In the years before 1973, when exchange rates were fixed by government intervention, the notion of an overvalued currency meant the dollar was overvalued if permitting it to float freely would cause its value to fall relative to other currencies. In other words, the exchange rate in a free market was the standard by which to judge whether an historically fixed exchange rate was currently overvalued or undervalued. Such an interpretation is no longer applicable. The dollar now floats freely relative to other currencies and its value reflects the consensus assessment by the world's financial markets through the interaction of supply and demand for the dollar. By the traditional standard, it is meaningless to say that the dollar is overvalued as it is to say that apples or typewriters are overvalued.

It is worth noting that the recent surge in the dollar's value can be viewed as doing nothing more than restoring the exchange rates that characterized world trade until the decade of the 1970s, when a succession of bad economic policies and the consequent deterioration of our economy led to a collapse of the dollar's value. Indeed, despite its recent surge, the dollar has barely regained the ground that it lost *vis-a-vis* the West German mark during the 1970s. When the exchange rate of the dollar is stated in terms of special drawing rights (SDRs), a weighted group of currencies used by the International Monetary Fund as a financial benchmark, the dollar in 1984 merely equals its 1970 strength. However, during that period, individual currencies such as the British pound, Italian lira, and French franc have varied more dramatically against the dollar, while other currencies such as the German mark and Swiss franc have seen a smaller degree of variation (see table 1).

TABLE 1
FOREIGN CURRENCIES PER U.S. DOLLAR

Currency	1970	1980	Average of February 11-15, 1985
German mark	3.65	1.82	3.28
French franc	5.53	4.22	10.03
British pound	2.40	2.33	1.10
Italian lire	627	856	2021
Japanese yen	358	227	260
Swiss franc	4.3	1.68	2.5

Why is the Dollar Strong?

Since 1980, the trade-weighted value of the dollar has risen by between 40 to 70 percent, depending on one's precise base and weighting method. There are many who believe that high U.S. interest rates relative to those prevailing abroad, are responsible for the large demand for dollar-denominated assets. Recent evidence, however, disproves this conclusion.

The dollar has remained strong even as U.S. interest rates fell and foreign interest rates rose. Between early September and mid-March, the 3-month Eurodollar rate fell by 275 basis points. By way of comparison, the Canadian Eurodollar rate fell by just 87 basis points, the Eurofranc rate eased by 22 basis points, and the Eurolira rate declined by 50 basis points. All other major Eurocurrency rates actually rose, with the Euromark rate rising 81 basis points and the Eurosterling rate rising by 275 basis points. Adjusting the Eurocurrency rates for changes in inflation yields the same results in terms of likely pressures on the dollar. The decline in the real Eurodollar rate during this period was 45 basis points. Yet, the real Eurosterling rate rose by 535 basis points, and the real Eurofranc rate rose by 158 basis points. However, during this period, far from easing, the trade-weighted exchange value of the dollar rose by 11.6 percent.

What explains this apparently perverse movement in the dollar exchange rate? There are a number of reasons for the strength of the dollar, the primary one being the remarkable performance of the U.S. economy. Lower tax rates, deregulation, and noninflationary monetary policy have produced strong gains in the potential real growth of the U.S. economy. The recovery in the U.S. has been solid and has moved rapidly into expansion, while inflation has dipped dramatically—at four percent, it is at its lowest since 1967. Unemployment has declined, with the U.S. economy creating over seven million new jobs since 1980. Second, the U.S. is perceived as a safe haven in a troubled world. Third, the relatively weaker economic performance among the European nations has further enhanced the perception of U.S. economic vitality. The economies of Europe are hobbled by closed markets, rigid labor systems and high taxes. Fritz Leutwiler of the Swiss National Bank states that, "The U.S. is seen by investors as young, flexible and dynamic and Europe old, schlerotic, and much less flexible." The respective strengths of the economies and currencies of the U.S. and Europe reflect, in large part, the wisdom or folly of their respective domestic economic policies. Fourth, the demand by foreign debtor countries for dollars to help service their large dollar-denominated debts has caused these countries to move from non-dollar to dollar assets. And fifth, the unique role of the dollar in the international monetary and trading system has added to its strength.

The Strong Dollar: A Problem?

Although competition from imports helps keep down the prices of domestically produced goods, several U.S. industries have been adversely affected by the dollar's strength. The strong dollar makes it difficult for certain U.S. industries, such as steel and textiles, to compete with foreign goods. Many other export-oriented industries also suffer. On the other hand, these industries, in order to effectively compete with imports, have been forced to seek more efficient production methods and drastically reduce costs. In the case of exporting firms, such action has made production leaner and more innovative, laying the foundation for a more efficient export sector. In addition, those industries purchasing imported raw materials or capital goods do so at a bargain, thanks to the dollar's strength

Popular wisdom has it that the strong dollar is the primary culprit for the flood of foreign manufactured goods into the U.S. But using the dollar as a whipping boy for the import wave ignores the important deep-seated structural changes behind this surge. To be sure, the strong dollar has only exacerbated the problem faced by U.S. exporters. Other important factors hurting them are: relatively high costs of production—both labor and capital—in the U.S. place American manufacturers at a competitive disadvantage *vis-a-vis* lower cost producers such as Korea and Japan; and until recently, U.S. manufacturers have generally ignored foreign markets.

Clearly, the strong dollar allows Americans to purchase foreign goods more easily and at lower relative costs than if the dollar were weak. But far from harming the U.S. economy, this helps it by keeping our inflation rate down. The general rule of thumb is that a ten percent change in the value of the dollar causes a 1 to 1.5 percentage point change in the overall rate of inflation. Based on this rule, the strength in the dollar since 1980 has reduced domestic inflation by almost two points per year. Foreign competition has also increased competition in U.S. labor markets, maintaining downward pressures on wages, and further restraining inflation. Wage increases last year were the lowest in 17 years.

The broad lesson here is that, compared with most, our economy is still self-contained. But our obsession with foreign threats blind us to this basic reality. Just because more industries face foreign competition does not mean our economy has completely fallen hostage to international influences. And just because U.S. companies can shop around the world for parts does not mean that American manufacturing is being obliterated. The mistake is to generalize the experiences of individual firms and industries to the economy as a whole. In the process, we overlook the immense advantages of the American economy. As the world's largest market, the U.S. is a perpetual cauldron for new products and applications. Having such a huge and diversified home market is a strength that no other nation can match.

Would a Weaker Dollar Help?

Although a weaker dollar would certainly help exporters and diminish the trade deficit, the process would take at least two years to occur since trade adjustments tend to lag changes in exchange rates. The initial impact on the trade balance may well be negative as price effects offset volume effects. This is likely to occur because price and volume adjustments to a change in the dollar's value will not come about instantaneously, but may, in fact, take several quarters. There is also a delay for the volume of exports and imports to adjust to price changes due to the costs involved in shifting sources of supply. For instance, a decline in the dollar's value may open up new markets for U.S. producers, but it will take time for them to acquire the capacity necessary to increase production.

It is far from certain, moreover, that a weaker dollar would aid U.S. exporters in the long-run. Recent history indicates that the balance of trade does not significantly improve or deteriorate in relation to the value of the currency. From 1976 to 1978, despite the plummeting dollar, the U.S. trade gap widened: It jumped from $17 billion to $40 billion during that period, and from then until 1982 remained in the range of $36 billion to $42 billion while the dollar lost 31 percent in value to the yen, 21 percent to the mark, and six percent to the pound and the franc.

Agricultural exports, a vital component of U.S. trade, would remain largely unaffected by a weaker dollar. Those exports, more than $38 billion in 1984, respond to world market incentives; their U.S. dollar price fluctuates sometimes as much as 50 percent in a year in response to temporary imbalances between available supplies from a few producing countries, including the U.S., and demand from a relatively small number of large importers. In fact, when grains or soybeans prices surge, the amount of money needed to pay for their importation escalates, bringing upward pressure on the rate of exchange. The dollar reacts to the international trade of those commodities rather than the other way around.

Thus, a weaker dollar might help particular export firms in the long run, but it is questionable whether the U.S. export sector as a whole would gain. The nature of foreign demand would determine the change in export income for each company, while some effects of a weaker dollar would affect exporters adversely.

Strong Dollar, Trade Deficit Link?

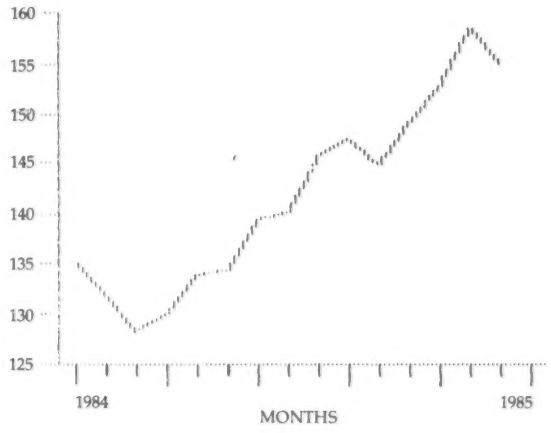
In 1984, the U.S. merchandise trade deficit rose to $107.4 billion (on a balance of payments basis)—an increase of 76 percent, in constant prices, over 1983. According to conventional wisdom, the dollar's appreciation is the cause of the increased deficit because the overvaluation, like a tax on exports, raises the prices charged in foreign currencies for U.S. exports, thereby tending to reduce these exports. In addition, it acts like a subsidy on imports because it enables foreign exporters to charge lower dollar prices and still make a profit (on costs they have incurred in their own domestic currencies). However, as historical evidence reveals, there is little correlation between currency values and export performance. During the decade of 1970-80, while the German mark and Japanese yen appreciated, their merchandise export volume rose by 71 percent and 150 percent, respectively.

The related proposition, namely that the strong dollar has crippled our export industries can also be disproved if we examine the relevant trade data. When the annual data for 1982 and 1983 are compared, the numbers reveal that our merchandise exports in 1983 were indeed lower than in 1982. However, these data mask the recent pattern of change in our exports. To accurately capture the change in our export performance, quarterly data, not annual data, must be examined beginning from the last quarter of 1982 (the quarter in which the recession ended). Although our export performance in 1984 increased over $20 billion compared with 1983, we still have not achieved the levels attained in the 1970s. But, contrary to what has been said, U.S. exports have made an unusually strong contribution to our recovery and are growing 30 percent faster than they grew in the average of previous postwar recoveries. The surge in imports, however, has been significantly stronger than average.

The rapid rise in U.S. imports from Japan and the European and developing countries should not be viewed in a negative light. The strong dollar (and hence, our trade deficit) has fueled the recovery abroad and has enhanced the export earnings capacity of the less developed countries. Data Resources, Inc. estimates that half of Europe's anemic growth last year—and 55 percent of the growth of output worldwide—stemmed from export sales to the U.S. In 1983, the worldwide figure was 43 percent.

Ironically, the high value of the dollar has contributed to a narrowing of the trade deficit in some product accounts. The strong dollar as well as lower oil prices have shaved about $20 billion from the trade deficit with the oil-producing countries since 1981.

CHART 1
TRADE-WEIGHTED EXCHANGE VALUE
OF THE U.S. DOLLAR



Are Official Interventions Useful?

A common European argument that is often heard is that the dollar could be checked by joint intervention of government financial authorities in the foreign exchange market. However, past evidence shows that official intervention has resulted in the loss of billions of dollars and has failed to stabilize exchange markets. Economist Dean Taylor cites the approximate $12 billion loss of the central banks of Canada, France, West Germany, Italy, Japan, Spain, Switzerland, Great Britain, and the U.S. during the 1970s to demonstrate this (*Official Intervention in the Foreign Exchange Market, or Bet against the Central Bank, Journal of Political Economy*, 1982). The volume of global currency transactions involving the U.S. dollar is not known with certainty. However, estimates fall in the range of $50 billion to $75 billion per day. Thus, the market is clearly too big for any central bank, or all the central banks together, to dictate for long any particular value of one currency in terms of another.

The Federal Reserve System and the U.S.Treasury have sold over $373 million in seven foreign exchange operations in the six months ending January 31. Despite the interventions, the trade-weighted value of the dollar still increased by eight percent (see Chart 1). Treasury Secretary Baker conceded that the interventions had some effect but could not keep the dollar from rising to new highs against other major currencies. Under the Reagan Administration, the U.S. has restrained from intervening except in cases of "disorderly" markets.

Another recent example of failed foreign exchange intervention by the major European central banks occurred on February 27. At one point, the dollar had plunged to a low of 3.18 marks from 3.99 on February 26 and 3.44 on February 25, reflecting anywhere from $500 million to as much as $1 billion in sales by the West German Bundesbank. Approximately $1 to $1.5 billion was unloaded in the foreign exchange markets by six central banks. But the intervention changed none of the fundamentals behind the dollar's strength. Indeed, following this concerted effort, the dollar recovered to 3.32 marks on February 28.

From the time that exchange rates started to float to the end of the 1970s, the central banks systematically lost money in their attempts to manage the exchange markets, without having any visible impact. Between March 1973 and the end of 1978, Japan's loss was $2.9 billion through official intervention; Switzerland lost $63 million loss from the beginning of 1975 to the end of 1976; and Canada lost $19 million from June 1970 to the end of 1974. Clearly, the objective of intervention should be that of promoting economic efficiency, not of slowing exchange rate movements. As recent history has shown, intervention in the foreign exchange markets is not an effective method to alter currency values. It tends to be very costly to a nation's Treasury while having little effect on currency values.

Conclusion

The U.S. dollar remains strong against the currencies of the nation's major trading partners, despite efforts by governments on both sides of the Atlantic to drive it down. It is likely that the dollar's recent slide in the market is the result of an accumulation of bad news—particularly the preliminary indications of unexpected weakness in the U.S. economy during the first quarter, seemingly rising inflationary pressures, an unexpected drop in the money supply (as measured by M-1), and the banking problems in Ohio. Although the anticipated future path of economic activity in the U.S. remains strong, the outlook for our trading partners is also one of continued growth. Such an outcome, together with a continued decline in U.S. interest rates, can be expected to place downward pressure on the dollar. Any decline in the dollar's value, however, can only be expected to be gradual.

Leading businessmen and politicians have repeatedly asked in despair what can be done about the strength of the dollar. The free interplay of market forces will lead to continuing readjustments that reflect basic underlying economic and political considerations. In addition, more uniformly sound policies and greater convergence of the economic policies of major industrialized countries would help reduce current exchange rate tensions. These countries should be encouraged to follow the same sound economic policies – tax cuts, deregulation, and lower inflationary monetary policies – that have strengthened the U.S. economy.

CAPITAL COST RECOVERY AND TAX REFORM

*by David R. Burton**

The cornerstones of the Economic Recovery Tax Act of 1981 (ERTA) were dramatically reduced individual tax rates and the Accelerated Cost Recovery System (ACRS), both of which have been an unqualified successes.

The 25 percent across-the-board individual tax rate cut has broad political support. It is becoming more widely recognized that, despite the recession, the personal income tax cut reduced federal revenues by only three percent. Further, following the rate reduction the wealthy are paying both higher taxes and a higher proportion of the overall tax burden.

ACRS, however, has come under increasing political attack as opponents allege that it is an expensive, ineffective, and outmoded subsidy to capital intensive industries. Nothing could be further from the truth. The ACRS, combined with the investment tax credit (ITC), substantially reduced the tax bias against investment. Consequently, during the recession, investment declined at much slower rates than usual, and during the recovery, investment increased at record rates. This new capital is the key to sustaining high rates of economic growth and an increased standard of living for all Americans. The bottom line is that ACRS has worked beyond virtually everyone's expectations to spur investment and growth in the American economy.

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What is the Accelerated Cost Recovery System?

Prior to ERTA, the U.S. depreciation system was extremely complex. The Asset Depreciation Range (ADR) system had over 125 different classes of equipment depreciable over different periods under varying declining balance rates (either the sum-of-the-years digits or straight line methods). Salvage value (the expected value of the asset at the end of the asset depreciation period) gave rise to additional complexities. Repair allowances and other considerations no longer relevant added still more complexity. Worse, these allowable depreciation ranges were inadequate and forced business to pay tax on illusory earnings.

The ACRS replaced this complex system with a simpler one consisting of four classes of property. Under ACRS, a taxpayer is allowed to deduct a percentage of the cost of his investment each year. The amount deductible is set forth in the easy to read table 1.

TABLE 1
THE ACCELERATED COST RECOVERY SYSTEM
(percentage recovered each year)

Recovery Year	Property Class			
	3-Year	5-Year	10-Year	15-Year
1	25	15	8	5
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	7
7			9	6
8			9	6
9			9	6
10			9	6
11				6
12				6
13				6
14				6
15				6

Three-year property includes automobiles, light trucks, tractors and certain other short-lived equipment. All other equipment falls under the five-year property category, while ten-year property refers to public utilities. Structures were recoverable in 15 years under the 1981 ACRS legislation; however, the Tax Reform Act of 1984 lengthened the recovery period to 18 years. The mere fact that one chart can describe the essence of ACRS is a testament to its simplicity.

Under ACRS, three-year property was eligible for a six percent investment tax credit and five-year property for a ten percent credit. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the ITC to four and eight percent, respectively.

The Economic Basis of the Accelerated Cost Recovery System

During the decade of the 1970s, investment levels in the United States declined because ADR depreciation allowances had become woefully inadequate by almost any standard. The real after-tax cost of capital skyrocketed as inflation increased the replacement cost of machinery and equipment. Further, high interest rates reduced the present value of the stream of deductions allowed by the ADR system.

The difference between the allowable depreciation that could be claimed by corporations on their tax returns, and the cost of replacing that capital resulted in a significant overstatement of corporate profits during the past decade. As a result, it was characterized by diminished investment, declining rates of economic growth and falling productivity. From 1960 to 1970 the total value of goods and services produced by the U.S. economy increased by 47.3 percent, nearly a four percent annual rate of growth. This compares with a total increase of only 35.9 percent, a 3.1 percent annual rate, in the period from 1970 to 1980.

Between 1960 and 1970 the output per hour worked for all persons in the economy increased by 32.2 percent. This compares with a total increase in the following decade of only 14.6 percent, less than half the 1960s' increase. Between 1977 and 1980 U.S. output per worker actually declined by over one percent. This decline in worker productivity played a significant role in the double digit inflation rates experienced towards the end of the 1970s. Because there were no productivity gains to offset wage increases, most wage increases were translated into higher prices.

The ADR system was biased against capital investment. Although most business expenditures were fully deductible in the year incurred, capital costs had to be recovered over a dozen or more years. Consequently, investment in plant and equipment became less attractive than other forms of economic activity. Firms would distribute dividends rather than invest, or make investments other than in plant and equipment. By reducing the return to investment, ADR prompted individuals to consume more. Consumption was made relatively more attractive because, as the after-tax return to investment declined, the cost of consumption in terms of investment income foregone, was reduced.

This failing in the ADR system could be rectified by a neutral tax system that allowed capital expenses to be deducted in the first year just like any other business expense. Only a tax system that allows expensing of capital investment (or its equivalent) will eliminate the tax bias against investment in plant and equipment. ACRS, combined with the ITC, is almost equivalent to expensing on a present value basis. Table 2 below reflects the present value of ACRS and the ITC, adjusted for the 1982 reductions in the investment credit for different discount rates. A value of 100 represents expensing while values below 100 represent capital cost recovery allowances that are less adequate than expensing.

As the table demonstrates, present law is very similar to first year expensing with discount rates of about nine percent.

TABLE 2
PRESENT VALUE OF ACRS AND ITC

DISCOUNT RATE	ACRS-ITC 3 YR	ACRS-ITC 5 YR
12%	97.1	97.1
11	98.0	98.4
10	98.8	99.9
9	99.7	101.0

The Effect of the Accelerated Cost Recovery System

The Accelerated Cost Recovery System went into effect in 1981. Because of ACRS, by the third quarter after the start of the last recession investment had declined by only 7.5 percent, compared to an average decrease of 14.2 percent during the previous seven postwar recessions. Furthermore, in the first eight quarters of the current recovery, investment was up 32.4 percent. This was more than double the rate of increase reported in the last six recoveries that lasted this long, and triple the increase that characterized the three most recent recoveries (see table 3).

TABLE 3
CAPITAL FORMATION DURING THE RECOVERY

Year Recovery Began	8 Quarter Percentage Increase in Fixed Nonresidential Investment	Investment/GNP Ratio 8 Quarters After Trough
1949	21.4	9.3
1954	19.2	10.5
1958	15.3	9.7
1961	10.1	9.0
1970	15.3	10.4
1975	14.2	10.2
Average	15.9	9.7
Average since 1960	13.2	9.8
1982 (most recent)	32.4	12.5

At the end of the eighth quarter of the current recovery, the investment to GNP ratio had risen to 12.5 percent, the highest level in recent American history. This compares with an average ratio of 9.9 percent for the last six recoveries. The 2.6 percentage point difference in the ratio means that at the end of 1984, we were investing about $93 billion dollars more per year than typically occurred. In other words, investment was 25 percent higher than would have been expected at a comparable point in the recovery.

Capital Cost Recovery in the Context of Tax Reform

Every one of the tax reform proposals now before Congress would change the capital cost recovery system. Tax reform plans such as the Kemp-Kasten Fair and Simple Tax (FAST) plan or the Roth-Moore Broad-Based Enhanced Savings Tax (BEST) plan would replace the present capital cost recovery system with expensing or its equivalent. Less discussed plans, such as the Heftel Cash Flow Income Tax, the Siljander Ten Percent Flat Tax, or the Hall-Rabushka 19 percent flat tax introduced by Senators DeConcini and Symms, would also expense investment. But many reform plans—particularly the Bradley-Gephardt Fair Tax and the Treasury's reform package—would return to a depreciation system similar to, or even worse than, ADR. They would also, like every reform plan, repeal the investment tax credit. Consequently, they would dramatically raise the cost of capital and reduce investment levels.

The Kemp-Kasten Fair and Simple Tax plan would replace ACRS and the investment credit with the Neutral Cost Recovery System (NCRS). Assuming an inflation-adjusted discount rate of 3.5 percent, NCRS would provide the present value equivalent to expensing. This plan would also index the capital basis for inflation, and maintain the same basic classifications as ACRS. ACRS three-year property would become NCRS four-year property, ACRS five-year property would become NCRS six-year property and structures would be recoverable over a 25-year period (see table 4). NCRS would effectively eliminate the tax bias against savings and investment, unless real interest rates climb higher. Investment levels under Kemp-Kasten would stay at their present high levels and, in light of the FAST's other positive attributes, economic growth would accelerate substantially.

The Roth-Moore BEST plan would phase-in first year expensing by 1990 and phase-out ACRS and the ITC. By 1990, all ACRS three- and five-year property would simply be expensed in the first year. BEST shares with FAST the virtue of eliminating the tax bias against investment, but it is simpler than NCRS. Under the plan, a certain designated percentage of a property's basis is expensed while the remainder is recovered under present law. The applicable percentage set forth in the bill would begin at 50 percent in 1985 and reach 100 percent by 1990, rising

TABLE 4
NEUTRAL COST RECOVERY SYSTEM
(percentage recovered each year)

Recovery Year	4-Year	6-Year	25-Year
1	16	10	4
2	30	20	6
3	30	20	6
4	30	20	6
5		20	6
6		20	6
7			6
8			6
9			6
10			6
.			" "
.			" "
.			" "
25			" "
	106	110	148

by ten percentage points each year. Thus, in 1986, a taxpayer investing $1000 would deduct $600 and depreciate $400 under ACRS. The ITC would also be applied to the $400. Although a new bill that addresses the corporate tax is being seriously considered, Roth-Moore at present only reforms the individual income tax. The proposal has been certified, in writing, by the Joint Committee on Taxation as being revenue and distributionally neutral.

The Bradley-Gephardt Fair Tax would replace ACRS and the ITC with the Simplified Cost Recovery System (SCRS). SCRS would return most property to lives of similar length to those under ADR. All property would be depreciable under a 250 percent declining balance method. The basis would not be indexed and recovery periods are as shown in table 5.

TABLE 5
SIMPLIFIED COST RECOVERY SYSTEM
(years)

ADR Class Life	SCRS Class Life
< 5.0	4
5.0 < 8.5	6
8.5 < 14.5	10
14.5 < 24	18
24 < 35	28
> 35	40

The Treasury Department has proposed replacing ACRS and the ITC with the Real Cost Recovery System (RCRS). RCRS would establish seven classes of property that bear no particular resemblence to the old ADR classes. The lives under the plan would be substantially

longer and a standard percentage of remaining basis would be recovered each year (i.e. the plan establishes geometric decay assumptions in the tax law). As this kind of system would never allow a taxpayer to deduct the full value of his investment, it would essentially "close-out" the depreciation once 85 percent of basis was recovered. Capital basis would be indexed under the plan. Most ACRS three-year property would become five-year property, and most ACRS five-year property would become 17-year property. Structures would be recoverable over 63 years (see table 6).

TABLE 6
REAL COST RECOVERY SYSTEM

Period (years)	RCRS Close-Out Depreciation Rate
5	32%
8	24%
12	18%
17	12%
25	8%
38	5%
63	3%

Table 7 compares the effect of various proposals on the cost of capital with adjustment for the proposed changes in the corporate tax rate. In other words, the RCRS cost of capital calculations are done assuming a 33 percent tax rate and 50 percent dividend deduction (with half of after-tax earnings paid in dividends), as provided by the plan. Present law assumes a 46 percent tax rate; Bradley-Gephardt, a 30 percent tax rate; and Kemp-Kasten, a 35 percent rate. A figure of 1.00 equals expensing. A figure below 1.00 indicates that the system is better than expensing. A ratio greater than 1.00 shows the degree to which the cost of capital is increased. Thus a figure of 1.12 would indicate that under the plan, the cost of capital would be 12 percent higher than under expensing.

TABLE 7
COST OF CAPITAL UNDER
VARIOUS TAX REFORM PROPOSALS

Recovery Method	Cost of Capital Inflation = 5% Real Discount Rate = 4%	Cost of Capital Inflation = 8% Real Discount Rate = 5%
ACRS-ITC 3 YEAR	1.00	1.03
ACRS-ITC 5 YEAR	0.99	1.04
ACRS 18 YEAR	1.36	1.44
NCRS 4 YEAR	1.01	1.02
NCRS 6 YEAR	1.01	1.04
NCRS 25 YEAR	1.05	1.15
SCRS 6 YEAR	1.05	1.07
SCRS 18 YEAR	1.15	1.18
SCRS 40 YEAR	1.24	1.27
RCRS 5 YEAR	1.02	1.03
RCRS 17 YEAR	1.08	1.09
RCRS 63 YEAR	1.20	1.22
EXPENSING	1.00	1.00

As the table shows, RCRS and SCRS substantially raise the cost of investing in plant and equipment while present law and NCRS are basically equivalent to expensing.

Policy Implications

Implementation of a capital cost recovery program like SCRS or RCRS would raise the cost of capital, reduce investment levels, lower productivity and make it difficult to sustain high rates of economic growth. This economically unjustified attempt to de-industrialize the U.S. economy would make it more difficult for American firms to compete internationally, reduce employment and ultimately, everyone's standard of living. The proper course is to enact a reform package that both reduces tax rates and provides adequate capital cost recovery allowances.

TRENDS IN COMMERCE
NOTES ON TABLE II

April, 1985

by
Martin Lefkowitz

Gross National Product (GNP)—The Department of Commerce's 'flash' estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—indicates that the growth rate may have slowed to a seasonally adjusted annual rate of 2.1 percent in the first quarter. The data appear to indicate that the consumer and government sectors continue to increase their spending, but that these increases are being offset by slowdowns in business investment and new home construction, and increases in imports. The revised estimate for fourth quarter economic activity reveals that GNP grew at an inflation-adjusted 4.3 percent annual rate, a slight downward revision from the estimate of 4.8 percent growth issued previously.

Money Supply—The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 1.2 percent in February, resulting in an 11.2 percent (seasonally adjusted annual rate) rise in the money supply in the latest three-month period.

This performance places the nation's money supply up 6.6 percent from its year-ago level. There is some speculation that the recent savings and loan closures in Ohio will result in a shift of funds from savings accounts (M-2), into checking accounts (M-1), and result in a short-term increase in the M-1 figures.

Employment—At 60.3 percent, the proportion of the adult population now working is higher than at any time in our history. Civilian employment—as measured by the monthly survey of households—increased by 434,000 persons (seasonally adjusted), in March to 107.1 million, bringing the employment increase in the last twelve months to three million. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 381,000 in March. This increase reflects the continued strength of service sector employment which rose by 280,000 workers, and a rebound in employment in the goods producing sector where over 100,000 more jobs were created in March than in February. The civilian unemployment rate remained unchanged at 7.3 percent in March, following a 0.1 percentage point decrease in February, and a 0.2 percentage point increase in January.

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased 0.3 percent in February following a 0.2 percent rise in January. The source of the February increase was to be found in the food, beverage, apparel, and housing components. Offsetting these increases was a sharp decline in gasoline prices and a modest decline in entertainment costs. Gasoline prices declined 2.5 percent in February and are now 17.3 percent below their peak level of March 1981. Food prices rose 0.5 percent in February due to an increase in fresh fruit and vegetable prices, resulting from adverse January weather.

Wholesale prices rose 0.2 percent in March after decreasing 0.1 percent in February. Although prices for food and energy fell in March, other consumer goods rose 0.6 percent, following a 0.2 percent increase a month earlier. The declines in energy and food prices were partially offset by increases in motor vehicles and other capital equipment. Prices at the wholesale level have increased in two of the last seven months and are unchanged from their level of last summer. The wholesale price index for finished goods in March was 0.3 percent higher than its year-ago level.

The more volatile part of the Producer Price Index, crude goods, declined 1.5 percent in March. Nearly all of the March drop was caused by a considerable decrease in the natural gas index, which had increased in February. Weak crude material prices appear to be a product of the strong dollar in international markets, and a surplus of farm products.

Housing Starts—The number of privately-owned housing units started in February declined to an annual rate of 1,638,000, 11 percent below the revised January rate of 1,841,000, and 26 percent below the number of starts a year ago. New single family homes were started at an annual rate of 1,121,000, up 6.7 percent from January. This represents the highest rate of single family starts during the past ten months. Building permits issued in February were down five percent from January, following three consecutive months of increases.

Industrial Production—Industrial production declined 0.5 percent in February, following a reported 0.3 percent increase in January. The February data indicated declines in all major sectors of the economy except for the defense and space industries, which increased output by 0.8 percent for the month.

The capacity utilization rate for manufacturing declined 0.6 percentage points in February as factories operated at 80.8 percent of capacity. Although the capacity utilization rate was at about the same level as a year ago, output has increased by 2.9 percent. This increase in output was due to a continued rise in available capacity and a higher level of investment.

Productivity—Revised data on productivity indicates that business productivity increased at a 3.8 percent annual rate in the fourth quarter of 1984. This resulted from a 5.5 percent increase in output, along with a 1.6 percent increase in the number of hours worked for all persons. This was a significant increase from the third quarter when productivity rose only 0.6 percent. At the same time, hourly compensation, which includes wages, salaries, supplements, and all employer payments to employee benefit plans, increased at a 4.4 percent annual rate. The more rapid rise in hourly compensation compared to productivity resulted in an increase in fourth quarter unit labor costs of 0.6 percent.

Interest Rates—At 10.5 percent the prime rate has remained virtually unchanged for nearly three months. Both short- and long-term rates declined in March. Three month Treasury bills which were 8.94 percent on March 1st fell to 8.32 percent by April 12th. Similarly, the 90-day commercial paper rate fell from 9.2 percent to 8.75 percent, while the federal funds rate fell from 8.74 percent to 8.47 percent. Thirty year U.S. Treasury bonds fell from 11.82 percent at the beginning of March to 11.4 on April 12th.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicates that failures were rising toward the end of the month. The index of business failures, which uses October 1983 as a base of 100, increased to 94.4 in the week ending March 8, 1985.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions)	Jan/85	238.0	237.8	235.8	0.1	0.9
Gross National Product ($B) [a]	I/85	3,828.2	3,758.7	3,553.3	1.8	7.7
Gross National Product (72$B) [a]	I/85	1,671.2	1,662.4	1,610.9	1.0	5.7
Money Supply (M1) ($B) [a]	Feb/85	569.3	562.7	534.2	1.2	6.6
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B) [a]	Feb/85	2,451.9	2,433.7	2,267.6	0.7	8.1
Personal Consumption Expenditures (72$B) [a]	Jan/85	1,085.9	1,085.0	1,052.8	0.1	3.1
Disposable Personal Income ($B) [a]	Feb/85	2,680.4	2,673.3	2,504.5	0.3	7.0
Disposable Personal Income (72$) [a]	Jan/85	1,192.9	1,192.3	1,141.8	0.1	4.5
Personal Savings Rate (%)	Jan/85	5.6	5.9	5.6	−0.3[b]	0.0[b]
Civilian Employment (millions) [a]	Mar/85	107.1	106.7	104.1	0.4	2.9
Civilian Unemployment Rate (%) [a]	Mar/85	7.3	7.3	7.8	0.0[b]	−0.5[b]
Average Hourly Earnings [a]	Mar/85	$8.54	$8.50	$8.25	0.5	3.5
Consumer Price Index (All Urban, 67 = 100)	Feb/85	317.4	316.5	306.7	0.3	3.5
Purchasing Power of the Dollar (1967 = $1.00)	Feb/85	0.315	0.316	0.326	−0.346	−3.368
Prime Interest Rate (%) April 4, 1985		10.5	10.5	11.5	0.0[b]	−1.0[b]
Retail Sales ($) [a]	Mar/85	110.5	112.7	104.5	1.9	5.8
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B)						
Before Tax	IV/84	230.6	224.8	225.5	2.6	2.3
After Tax	IV/84	142.3	141.7	141.1	0.4	0.9
Industrial Production (67 = 100) [a]	Feb/85	164.7	165.5	160.0	−0.5	2.9
Capacity Utilization Rate (Mfg.) (%)	Feb/85	80.8	81.4	80.9	−0.6[b]	−0.1[b]
New Housing Starts (thou. units) [a]	Feb/85	1,638.0	1,841.0	2,208.0	−11.0	−25.8
Net Business Formation (67 = 100)	Feb/85	118.0	117.3	117.2	0.6	0.7
New Business Incorporations (Thousands) [a]	Sep/84	51.9	51.7	50.4	0.3	2.9
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100) [a]	IV/84	159.8	159.5	157.1	0.2	1.7
Unit Nonlabor Costs (77 = 100) [a]	III/84	154.5	152.3	150.9	1.4	2.4
Producer Price Indices (67 = 100)						
Crude Materials [a]	Mar/85	311.5	316.1	337.1	−1.5	−7.6
Intermediate Goods [a]	Mar/85	318.4	318.9	319.6	−0.2	−0.4
Finished Goods [a]	Mar/85	292.7	292.1	291.5	0.2	0.4
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100) [a]	Feb/85	569.9	585.0	519.8	−2.6	9.6
Federal Government Debt Outstanding ($B)	Dec/84	1,667.4	1,635.5	1,415.3	2.0	17.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B) [a]	IV/84	367.2	368.6	346.1	−0.4	6.1
Imports of Goods & Services ($B) [a]	IV/84	423.2	459.3	375.9	−7.9	12.6
Balance on Goods & Services ($B) [a]	IV/84	−56.0	−90.7	−29.8	−38.3	87.9
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100)	Feb/85	167.5	166.4	166.5	0.7	0.6

NOTES: [a] Seasonally adjusted data
[b] Percentage point difference

This was slightly below the 96.4 index for the business failure index reported a year ago. However, the number of March business discontinuances was significantly above the year ago level. From January to mid-February the number of business discontinuances was about the same as in 1984.

The latest available data indicates that there were 478,398 new business incorporations in the first nine months of 1984, a six percent increase over the same nine month period in 1983. After seasonal adjustment, the number of new business corporations formed in September of 1984 increased 0.3 percent from the previous month. The states with the largest of year-to-year increase in new business corporations were Vermont (up 26.5 percent), Maryland (up 25.8 percent) and Arkansas (up 20.5 percent). Regionally, New England showed the largest gain for 1984 compared to 1983, with new incorporations up over 13 percent from a year ago. At the current rate, new business incorporations in 1984 will exceed 635,000 for the year—a significant increase over the 600,400 new corporations formed in 1983 which was a record year.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, rose by 9.4 percent this February compared to its year ago level. In the first five months of fiscal 1985, federal expenditures increased 11.8 percent, about three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year ago level. Only one-fifth of the increase is the result of rising defense spending. Receipts for the month of February were up 12.8 percent from the same month a year ago due to large increases in personal income and social insurance tax receipts. Receipts for the first five months of the fiscal year are up 11.9 percent and are rising faster than income. The double digit rise in federal outlays, despite rather modest inflation, indicates that the deficit problem is the result of uncontrolled federal outlays rather than inadequate tax revenues.

Personal Savings—According to Department of Commerce data, personal savings fell in the first two months of 1985. Savings declined to about 5.5 percent of after tax income from 6.2 percent in the fourth quarter of 1984. Personal savings in 1984 were nearly $40 billion higher than they were in 1983, with the percentage of income saved increasing from 5.0 percent in 1983 to 6.1 percent in 1984. This means that sixteen percent of the increase in after-tax income in 1984 went into savings.

Retail Sales—Retail sales dropped 1.9 percent in March following a 1.6 percent rise in February. Although the month-to-month decline was the largest in seven years, it came on the heels of an unusually strong rise in sales in February. The February rise was indicative of an across-the-board increase in sales in most major retail sectors. The March department store sales figures show a 4 percent drop in auto sales and a 2.3 percent decline in department store sales. But those unusual declines follow large increases in February of 1.7 percent in autos and five percent in department stores. Meanwhile most major retail chain stores. aided by an early Easter, showed strong year-to-year sales increases for March.

Trade Deficit—The trade deficit, on a goods and services basis, decreased from an annual rate of over $90.6 billion in the third quarter to a revised 56.0 billion in the fourth quarter. The improvement is the result of a $13.6 billion increase in net exports compared with a decrease of $15.6 in third quarter exports. The fourth quarter data also reflected a large decrease in imports compared to the third quarter when imports were rising. The deteriorating international trade position of the U.S. is best exhibited by the fact that the deficit for goods and services which was $64.2 billion in 1984, was only $8.3 billion in 1983, following surpluses in 1981 and 1982. The monthly data on merchandise trade show a deficit of $11.5 billion in February. The increase in the merchandise trade deficit, which occurred in spite of a 1.3 percent decline in imports, resulted from a sharp (eight percent) drop in exports.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.7 percent in February, with five of the ten available indicators up. This follows a revised 1.5 percent increase in January. The index has now risen for three successive months.

NATIONAL CHAMBER FOUNDATION TAX STUDIES UNDERWAY

The National Chamber Foundation (NCF) will soon complete two important tax studies that provide analysis crucial to the current debate on reforming the U.S. tax system.

The first study, by Dr. Michael Boskin of Stanford University, examines how the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC) have contributed to capital formation, investment, and productivity.

The second study, by Dr. Gregory Ballentine, formerly chief economist at the Office of Management and Budget (OMB), examines the level of *all* taxes paid by cor-

porations to determine the effective corporate tax rate. Accurate data in this area is needed for critiquing any proposed shifts in the tax burden.

The business community and key policymakers will be invited to hear the findings of these NCF studies at a conference scheduled in early June. Those interested should contact Ms. Gale Thompson at (202) 463-5552.

The National Chamber Foundation is a non-profit, public policy research organization affiliated with the U.S. Chamber of Commerce.

ACCRA COST OF LIVING INDEX

The American Chamber of Commerce Researcher's Association, (ACCRA) publishes intercity cost of living comparisons for some 200 cities in the country. The ACCRA index has appeared on a quarterly basis since 1968, and the mix of cities varies from quarter to quarter. The following table presents the latest data from the ACCRA's fourth quarter 1984 cost of living index for 20 cities picked at random. The average for all participating cities is 100; therefore, a value of 145.9 for San Francisco is interpreted as meaning that the cost of living in that city is 45.9 percent above average. Similarly, a value of 96.6 for Greensboro means that the cost of living in that city is 3.4 percent below the average for all the communities listed. For more information about cost of living statistics, contact the Lexington Chamber of Commerce, Lexington, Kentucky, (606) 254-4447.

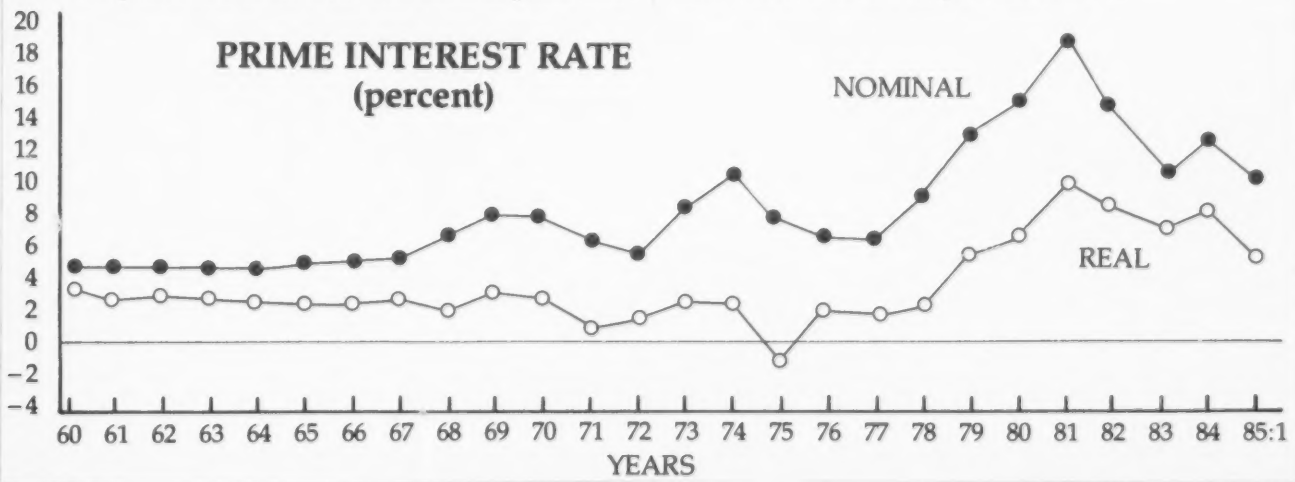
San Francisco, CA	145.9
Anchorage, AK	136.5
New York, NY	134.4
Fairfield, CT	122.9
Boca Raton, FL	118.2
San Diego, CA	113.4
Seattle, WA	110.5
Denver, CO	109.6
Kalamazoo, MI	105.1
Pittsburgh, PA	104.4
Des Moines, IO	102.1
Birmingham, AL	101.7
Tucson, AZ	99.8
Oshkosh, WI	99.3
Greensboro, NC	96.6
Huntsville, AL	94.3
Fort Smith, AR	92.4
Joplin, MO	90.9
Pueblo, CO	88.4
Clinton, MO	88.3

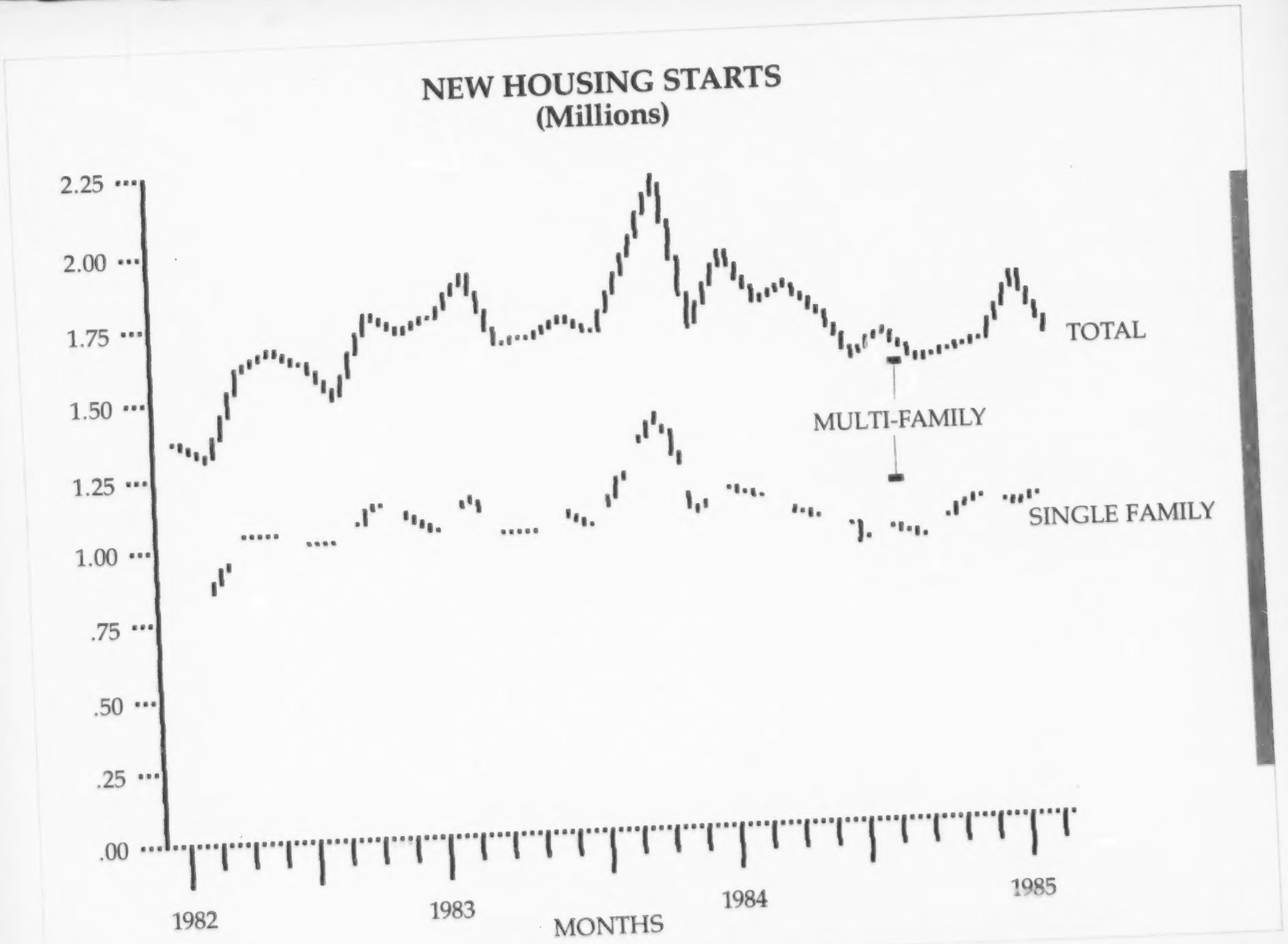
ECONOMIC OUTLOOK AVAILABLE ON MICROFICHE

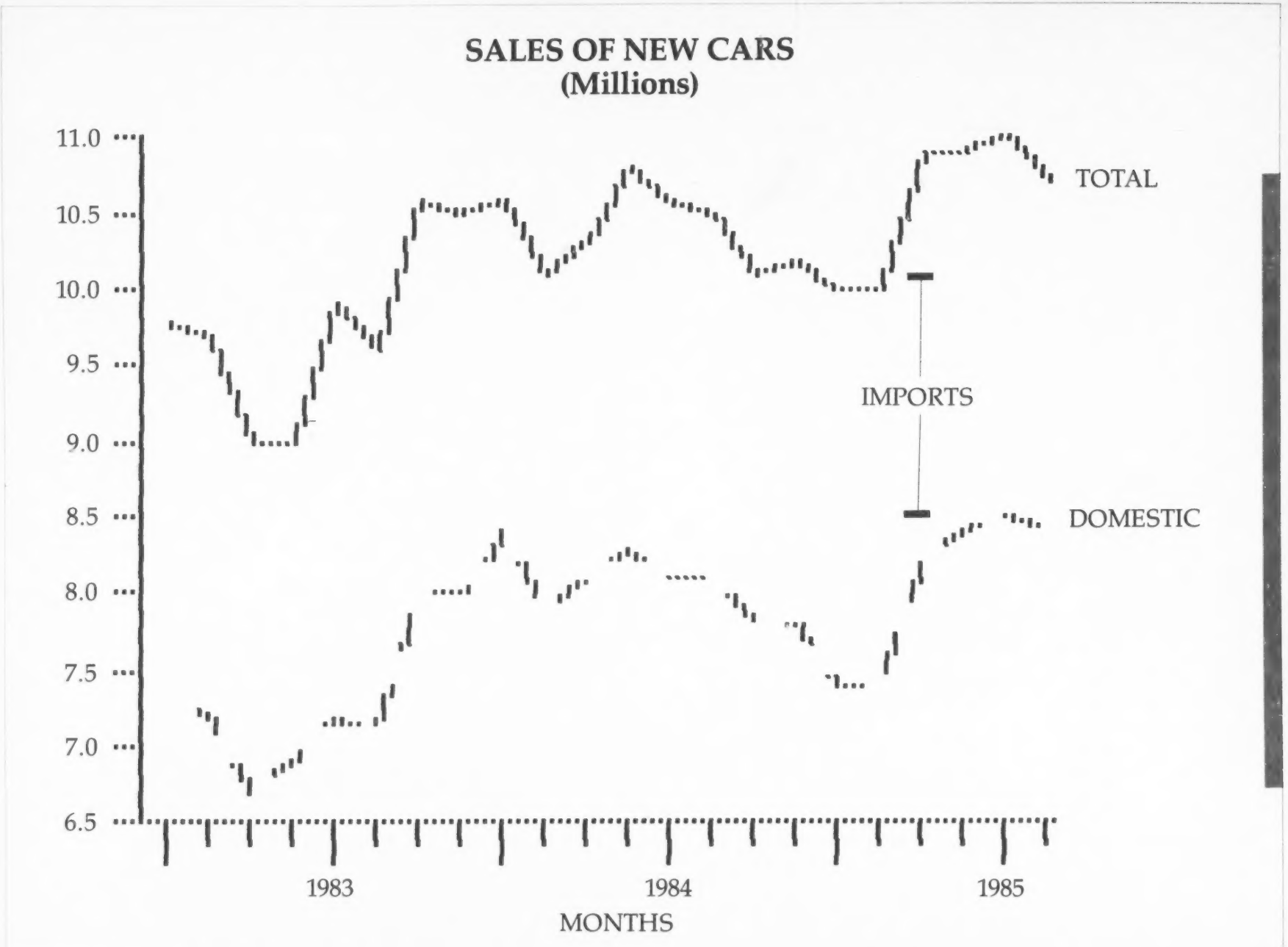
ECONOMIC OUTLOOK is available on microfiche in the Statistical Reference Index collection maintained by the Congressional Research Service. For information concerning this service, please write or call Congressional Information Service, Inc., 4520 East/West Highway, Bethesda, MD 20814, (301) 654-1550.

THE NOMINAL AND REAL PRIME INTEREST RATE

Although the real rate of interest is a key economic variable, it cannot be directly observed. A crude measure of it is derived by subtracting the rate of change in overall inflation (i.e. the implicit price deflator for GNP), from the nominal interest rate. The chart shows the nominal and real prime rate since 1961. The nominal prime rate peaked at 18.9 percent in 1981 and has retreated steadily since then, averaging 10.5 percent since mid-January. As of the first quarter of this year, the inflation rate was at its lowest point since 1977, the nominal prime interest rate was at its lowest point since 1978, and the real prime interest rate, at its lowest point since 1979.




NEW HOUSING STARTS
(Millions)
2.25
2.00
1.75
1.50
1.25
1.00
.75
.50
.25
.00
TOTAL
MULTI-FAMILY
SINGLE FAMILY
1982
1983
1984
1985
MONTHS


SALES OF NEW CARS
(Millions)
11.0
10.5
10.0
9.5
9.0
8.5
8.0
7.5
7.0
6.5
TOTAL
IMPORTS
DOMESTIC
1983
1984
1985
MONTHS